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Q2 2020 Zumiez Inc Earnings Call - Final

Presentation

OPERATOR: Good afternoon, ladies and gentlemen, and welcome to the Zumiez Inc. Second Quarter Fiscal 2020 Earnings Conference Call. (Operator Instructions)

Before we begin, I'd like to remind everyone of the company's safe harbor language. Today's conference call includes comments concerning Zumiez Inc. business outlook and contains forward-looking statements. These forward-looking statements and all other statements that may be made on this call that are not based on historical facts are subject to risks and uncertainties. Actual results may differ materially.

Additional information concerning a number of factors that could cause actual results to differ materially from the information that will be discussed is available in Zumiez filings with the SEC.

At this time, I will turn the call over to Rick Brooks, Chief Executive Officer. Please go ahead, sir.

RICHARD M. BROOKS, CEO & DIRECTOR, ZUMIEZ INC.: Hello, and thank you, everyone, for joining us on the call. With me today is Chris Work, our Chief Financial Officer. I'll begin today's call with a few remarks about the second quarter. Then I'll share some thoughts on back-to-school and the rest of the year, before handing call over to Chris, who will take you through the numbers. After that, we'll open up the call to your questions.

Amidst the most difficult operating conditions the company has ever faced, we delivered better-than-anticipated results. To put some context around our recent performance, when the second quarter started in May, we had only 65 stores opened, which is just 9% of our entire store base. By the end of May, that number had increased to 492 stores or 68% of our store base. By the end of June, we hit our peak with 691 stores or 96% of our store base open.

Then in July, as a result of governmental orders, we closed a total of 69 stores in California and Australia, and ended the second quarter with 645 stores or 90% open. For the quarter, our stores were open for 73% of potential operating days. Despite stores being opened 27% fewer days than a year ago, second quarter 2020 revenue increased 9.6% as stores that were open, combined with digital activity, comped up 37.3%.

Our top line performance was highlighted by robust full price selling across all geographies. As demand for our distinct and differentiated merchandise assortments and the continued efforts of our teams drove much stronger results than we had anticipated. By geography, we experienced stronger growth in our international markets with Canada, Europe and Australia, all showing significant comparable sales gains and double-digit total sales growth despite closures in the period.

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As we discussed on our Q1 call in June, from the onset of the pandemic, we made some difficult near-term decisions around our expense structure in order to weather this crisis and emerge in a position of strength. This included laying off virtually all of our part-time staff, suspending all hiring, eliminating substantially all planned fiscal 2020 bonuses and eliminating the majority of merit raises. Other operational changes we have made during Q1 and across Q2 include reducing store labor to reflect restricted operating hours, eliminating travel across all areas of the business, canceling national training and certain marketing events and looking for the other costs that could be eliminated or delayed as a result of the current environment.

These combined actions, coupled with the increased sales activity, allowed us to significantly leverage the business, contributing to second quarter earnings per share of $1.01 and favorable cash generation, with close to $300 million in cash and marketable securities on our balance sheet and no debt, we believe we are well positioned to navigate what is likely to be a volatile operating environment over the next few quarters while investing strategically in the business.

These results in this environment underscore the strength of our brand and culture and speaks to the ability of our business model to adapt to change. We have discussed at length over the years the significance of our culture and brand and how they serve as critical competitive advantages that have helped us win throughout our 40-plus year history. The most significant component of our culture and brand has always been and will always be our people.

The investment we made in supporting our full-time employees throughout the pandemic paid dividends in the second quarter as they were able to quickly and successfully execute the reopening of nearly our entire store base while continuing to service and engage with our customers physically and digitally. As it has in the past, I am confident that our unwavering commitment to our people will continue to further set Zumiez apart from the competition and meaningfully benefit our long-term performance.

Looking ahead, there is still a great deal of uncertainty about the state of retail and the global economy due to the impacts from COVID-19. We are currently experiencing the effects the health crisis is having on back-to-school as many states and districts around the country have delayed the start of the new school year or decided to begin with virtual instruction. As a result, we did not see the sustained lift in demand we typically do starting in late July and running through early September.

To date, the third quarter has been meaningfully impacted by the timing of back-to-school and the impact of virtual learning, but has generally gotten stronger each week as we've moved through the quarter. At this point, we believe we are likely to see a more prolonged back-to-school season with some demand shifting out to later in the third quarter. However, we are currently planning the entire season to be meaningfully below the prior year.

With regard to the upcoming holiday season, there are also a number of unknowns as is unclear what happens with the virus as we get into winter, how governments and individuals will respond, what impacts a pending election could have on our results as well as the uncertainty around the financial condition of the consumer. What I do know is that Zumiez is well positioned to pivot to meet the needs of our customers wherever, whenever and however they want to engage with us, thanks to our dynamic teams and our 1-channel mentality.

Periods of significant change create opportunities. Companies that have the right people, strategies and resources in place can take advantage of times like this to advance their brand and business. While Zumiez isn't fully immune to disruption created by the pandemic, we do believe the current environment will accelerate further consolidation globally and that our focus on the consumer will lead to further wallet and mind share gains as we emerge from the crisis.

We must be smart in how we navigate the business challenges, while also looking for long-term strategic investments that will set us up for the future. These include great real estate opportunities, new tools within our omnichannel formats and other strategic investments to support the next era of intimacy and now with our customers. The strength in our financial position can be a significant advantage in these times.

I have great confidence in our teams and their proven ability to navigate through unforeseen challenges. Our response to pandemic has highlighted the strength of our culture and brand, and bolstered my optimism about emerging even stronger from this current crisis.

With that, I'll turn the call to Chris to discuss the financials.

CHRISTOPHER CODINGTON WORK, CFO, ZUMIEZ INC.: Thanks, Rick, and good afternoon, everyone. I'm going to start with a few high-level comments on the financial strength of the business, review our second quarter and then provide an update on the quarter-to-date sales through Labor Day before discussing a few updates on the full year.

We entered fiscal 2020 in a strong financial position with cash and marketable securities over $250 million, and coming off the highest earnings per share in the history of our company. This resulted from years of commitment and hard work by our teams, coupled with strong financial planning. Now for the closure and subsequent reopen, we have continued to see the strength of our 1-channel model with our teams working diligently to serve the customer.

The business ended the second quarter in a strong financial position. Cash and current marketable securities increased 58.6% to $299.1 million as of August 1, 2020, compared to $188.6 million as of August 3, 2019. The increase in cash and current marketable securities was driven by cash generated through operations, including deferment and reductions of $41.5 million composed of landlord payments, lower inventory levels, extended vendor terms and deferred payroll tax payments. In addition to net income improvements related to abatements, credits and expense reductions, this increase was partially offset by $13.4 million of share repurchases through the company's stock buyback program prior to our stores closing due to COVID-19 and other planned capital expenditures.

As of August 1, 2020, we have no debt on the balance sheet and continue to maintain our full unused credit line of $35 million. We ended the second quarter of 2020 with $126.7 million in inventory compared with $151.1 million of inventory last year, a decrease to $24.4 million or 16.1%. During the first quarter, our merchandising teams canceled or pushed out orders in Q1 to curb the impact of declining sales due to store closures, with demand in reopen stores exceeding our expectations in the second quarter, we increased our planned receipts meaningfully and still ended the quarter light on inventory across most categories with certain areas of our business significantly impacted by a delayed supply chain.

Overall, the inventory on hand is well positioned and selling at a favorable margin entering the third quarter.

Turning to the income statement. Second quarter net sales increased 9.6% to $250.4 million compared to $228.4 million for the second quarter of 2019. The increase in sales was driven by a 37.3% increase in comparable sales which includes reopened stores and our digital activity, partially offset by store closures during the period. Breaking down the comparable sales further, we saw meaningful strength, both digitally and as our stores reopened, with comparable sales in stores over 20% and digital comparable sales for the quarter over 122%.

As Rick mentioned, our stores were open for roughly 73% of potential operating days during the second quarter of 2020. And with the highest concentration of stores opened in June, we saw our strongest results in that month.

From a regional perspective, North America net sales increased $16.5 million or 8% to $223.5 million. Other international net sales, which consist of Europe and Australia, increased $5.5 million or 25.4% to $26.9 million. Excluding the impact of foreign currency translation, North America net sales increased 8.2% and other international net sales increased 25.8% for the quarter.

From a category perspective, all categories were up in total sales with the exception of footwear with hardgoods being our most positive, followed by men's clothing, women's clothing and accessories. Second quarter gross profit was $90.9 million compared to $77.2 million in the second quarter last year, and gross margin was 36.3% compared to 33.8% a year ago. The 250 basis point increase in gross margin was primarily driven by a 170 basis point increase in product margin, 160 basis point decrease in

store occupancy costs, a 50 basis point decrease in distribution costs and 20 basis point decrease in inventory shrinkage. This was partially offset by a 160 basis point increase in web shipping costs due to increased web activity as a result of COVID-19 related to store closures. However, shipping costs leveraged to the prior year were compared to total web sales.

SG&A expense was $57.7 million in the second quarter compared to $65.5 million a year ago. A decrease of $7.8 million or 11.9%. SG&A expense as a percent of net sales decreased 560 basis points for the quarter to 23.1% of total sales. The decrease was primarily driven by a 240 basis point decrease in our store wages, a 100 basis point leverage in other store costs, a 70 basis point decrease due to governmental payroll credits, a 70 basis point decrease in corporate costs, a 40 basis point decrease in corporate wages, a 30 basis point decrease in the accrual of annual incentive compensation and a 20 basis point decrease in national training and recognition events.

Operating income in the second quarter of 2020 was $33.1 million or 13.2% of net sales compared with operating income in the prior year of $11.7 million or 5.1% of net sales. During the quarter, we recognized flow through on incremental sales of almost 100% based on the factors outlined above and our ability to adjust quickly in this challenging time.

Net income for the second quarter was $25.4 million or $1.01 per share compared to net income of $9 million or $0.36 per share for the second quarter of 2019. Our effective tax rate for the second quarter of 2020 was 26% compared with 30.7% in the year ago period.

Now to our fiscal third quarter-to-date sales results. We are providing quarter-to-date sales through Labor Day, Monday, September 7, as this time period is more comparable to the prior year given the shift in the Labor Day holiday. Total third quarter-to-date sales for the 37 days ending September 7, 2020, were down approximately 14% compared with the same 37-day time period in the prior year ended September 9, 2019.

For this same time period, our stores were open for 91% of the potential operating days due to ongoing mandated store closures, primarily in California, Hawaii and Australia. Total comparable sales for the 37-day period ended September 7, 2020, were down 5.1%. By channel, our open store comparable sales decreased 10.7%, and our e-commerce sales increased 27.4%. The quarter-to-date comparable sales decrease discussed above was driven by a decrease in transactions, partially offset by an increase in dollars per transaction. Dollars per transaction increased due to an increase in units per transaction offset by a decline in average unit retail.

Quarter-to-date, total sales increased in our hardgoods category. All other categories were down in total sales quarter-to-date with footwear being the most negative followed by men's, women's and accessories. Our overall quarter-to-date performance reflect the delayed start to back-to-school with many states and districts pushing back their start date. The impact to schools going back virtually and continued store closures. Looking at the weekly cadence of our results in August, they generally improved each week and we continue to believe that there may be opportunity for a prolonged back-to-school season into September and October.

Due to limited visibility to the business, we will not be providing guidance for the third quarter of 2020 or the fiscal year. That said, we do want to give a few thoughts on how we're looking at 2020. We are expecting sales for the third quarter to be down to the prior year. However, we believe our results will be better than the previously disclosed third quarter-to-date sales decline of approximately 14%. We experienced a product margin increase of 170 basis points in the second quarter, and a positive start to the third quarter.

We are managing inventory tightly and working with our brand partners to navigate this environment. In the third quarter, we expect to see a benefit in product margin to the prior year, but do not anticipate that it will be as significant as the year-over-year growth experienced in our second quarter.

We continue to manage costs across the business, understanding this challenging environment and limited visibility. Through the first 6 months, we have seen significant reductions in certain expenses as we work to align the cost structure to the sales loss during our closure and potential for greater economic losses as we move through the year. We are currently planning SG&A expenses across the business to be down 12.5% compared with 2019 associated with reductions in store operating hours, travel and training, planned capital, incentive compensation and many other benefits.

With the potential variability in performance over the back half of the year, this estimate could increase or decrease as we gain more visibility to the sales trends, our ability to adjust expenses and the potential for noncash impairments. We now expect to open approximately 10 new stores in 2020, including 2 stores in North America, 7 stores in Europe and 1 store in Australia. This is down from our plan coming into the year of 20 new stores. We expect capital expenditures for the full 2020 fiscal year to be approximately $11 million compared to $19 million in 2019 and our original plan for 2020 of between $18 million and $20 million.

The majority of our capital spend will be dedicated to new store openings and planned remodels. We expect the depreciation and amortization, excluding noncash lease expense, will be approximately $24 million, down slightly from the prior year. And we are currently expecting -- projecting our share count for the full year to be approximately 25.3 million shares. At this point, we are not expecting any further share repurchases until we have better visibility into the business.

With that, operator, we'd like to open the call up for your questions.

Questions and Answers

OPERATOR: (Operator Instructions) Our first question comes from Sharon Zackfia with William Blair.

SHARON ZACKFIA, PARTNER & GROUP HEAD OF CONSUMER, WILLIAM BLAIR & COMPANY L.L.C., RESEARCH DIVISION: Congratulations. I guess a question on the inventory position. I know -- I think it was, Chris, that you said you thought you were in a good position, but it looks pretty down even relative to the sales you indicated for back-to-school. So I mean, are there pockets of scarcity in your inventory at this point? And how well positioned are you to chase sales if it's a prolonged back-to-school? And then just curious on your thoughts on store development beyond 2020, considering you're rebounding and doing much, much better than most others in this environment?

CHRISTOPHER CODINGTON WORK: Sure, Sharon. Happy to start with the inventory, and then we'll tackle the store question. From an inventory perspective, as I mentioned in the prepared remarks, it's been obviously a roller coaster of a year. As the first quarter hit us and the store closures, we -- our buying teams worked very diligently to work with our vendors to push out products, canceling over $100 million of purchase orders.

And then once we opened in the latter part of April and into May, we started to really see elevated results from where our expectations were. And that put them in the opposite situation of really chasing. And then I think you couple that with where we have been from getting the supply chain up and running created quite a few challenges as we move through the period. So a really great testament to our buying teams of reacting and bringing product in and our distribution and operations teams and moving it through the channel.

And ultimately, our store teams in executing on how they did with our customers, both physically in store and digitally, but it was not without challenges. And so I think as we look at inventory and we look at how we ended the quarter, we would definitely say we were lighter than we wanted to be. I would tell you, inventory is very clean. So when I say we execute inventory in a good position, we feel very good about the makeup of our inventory, but we certainly would have liked to have had more of it specifically in categories like hardgoods and footwear, which were probably 2 of our more challenging areas.

I think this also gets into kind of the supply chain and how we're working through that. And I know there's been a lot of retailers who have talked about the varying degrees of challenges in the first 6 months of the year. And well, as we look at this, the challenges sort of started, which is getting back up and running after the closure period and then kind of move to getting product -- getting all the products we want, getting it at the timing of our deliveries and then the increased demands on the overall ecosystem, including getting things from our distribution center to our stores as well as our stores to customers just based on the elevated volume levels.

And then I think as we look forward, we also are thinking about the potential for some peak surcharges that are out there and what other operating challenges we might have. So as you can imagine, we continue to try to plan for this, and we believe that our 1-channel philosophy is actually puts us in a pretty good position in how to work through this because we're shipping generally much closer to the customer. We have a distributed network of stores doing the shipping, which has been pretty helpful. And we're continuing to work with our shipping partners as well as execute our own mitigate -- mitigation techniques to the risks that are in front of us.

So I think, overall, as we continue to manage through this, as we've moved through August, we started to see the inventories rightsized a little bit more. Again, we continue to feel good about our inventories. But as you pointed out, there were some probably opportunities that we had and some sales -- potential sales misses where we just weren't able to get inventory in to satisfy the consumers' demand.

RICHARD M. BROOKS: And Sharon, the second part of your question relative to our store footprint and thinking about store development beyond 2020, I think to really address that question, I want to break it into 2 parts. And so let's talk about the U.S. market, and then we'll talk about our international markets. So I think it will help us understand a little bit about the differences between both markets and the challenges and opportunities in each market.

So in the U.S., you know that we -- I think it's pretty clear to most people today that we probably have too many retailers in the market, too much retail space, and we also probably have too many malls. So we -- as you know, we obviously believe for a long time that's really been -- this is being driven by the empowered consumer and the power that they now have through complete transparency of inventory availability, the digital-first strategy, right, that consumers have in searching and finding product. So we expect to see that this consumer-driven cycle is going to be what really drive the consolidation of retailers. We simply -- most retailers simply don't need as many locations. And it's also with struggling, it's what's causing malls to struggle and threatening some mall survival.

Now we also think that the pandemic has really accelerated both of these cycles. I think there's plenty of evidence looking at the current marketplace that that's probably true. But we believe in the long run that the rationalization around retail and malls is going to be good for us and will drive -- what will drive really help us drive share consolidation for us as we're positioned, I really believe to win our segment of this consumer world. So I'll ask Chris to share a few more thoughts around the U.S. market, and then I'll talk about the international market.

CHRISTOPHER CODINGTON WORK: Sure. I think what I'll try to do is just kind of talk about the strategy of real estate and how we think about store units. And we've said for quite some time, we really don't want to have 1 more unit than we need to in any given geographic area. And so we're definitely moving towards the trade area concept, looking at stores and web to serve our customer and believe that they definitely work together. And so from a strategy perspective, I mean, there's definitely a short-term here in regards to where we stand with COVID and working with our landlord partners. And I can tell you we've worked really closely to manage through what's a difficult time for both of us. And as we mentioned on our Q1 call, we did hold back on significant portions of our April, our May rent, and even in some cases, our June rent. As we work through this process, we're not going to give a lot of detailed color on where we stand with each landlord and the amount of abatements or deferrals other than some of the high-level commentary we gave as part of our prepared remarks around how much deferral is on -- of all of our deferrals, leases, the inventory balance, the payroll and our AP as well as we gave some color around occupancy and

how taking our P&L from a leverage perspective, but what I can say is we've worked very hard with our landlord partners to find compromises that I think are working for both sides.

And we have quite a few of the process done and behind us, but we also have quite a few agreements that we've got to get documented and still complete in front of us. So we continue to work through it. And longer-term, our strategy is to really manage risk when it comes to the number of stores. And as Rick talked about, in the U.S., most likely being overmalled. And so we look at it with the bottom 10%, 20% of our stores. Obviously, trying to keep them on very short deals to allow us flexibility in how we navigate in those markets. Definitely looking at each unit or each store is what its role in the trade area is and how we think about stores, both in terms of their 4-wall sales as well as the fulfilling and trying to align it to optimize our store count within each trade area.

And doing this over a multiyear view to really kind of say, "Okay, how profitable can we be?" And coupling that with data that we're learning constantly from our STASH data and then just kind of looking at how does this all play together to serve the customer, knowing that certain centers, high-volume centers are still going to have long-term demand and other maybe lower volume centers have peak seasonal needs, but can also support the high-volume centers from a fulfillment perspective over the long term. So as we look at that bottom 20%, we've talked about this over the years. We have roughly 75% we can get out of in the next 3 years, over 80% in the next 5 years. And that gives us this kind of comfort level around how we can maneuver in this cycle.

So that's kind of strategy component, I'll kick it back to Rick just to talk about the international side.

RICHARD M. BROOKS: Great. Thanks, Chris. So -- and just summarizing all that, Sharon, relative to U.S., as it relates to, again, your question around store development, we really see the U.S. more as reflecting of how a market is going to be rationalized, both in terms of the number of malls that will be in the marketplace as well as retailer store footprint. And then how we're going to optimize our business to capture share in the U.S. marketplace and to grow earnings through the concept of trade area, trade area execution.

Now the international marketplace, I think it's a bit different. On the international real estate side, there's no doubt that the empowered consumer is -- that is a universal trend today driven by smart technology, that's still driving on global marketplaces in our international marketplaces. That's still driving retailer consolidation.

Now on the mall side, they're generally pretty rationalized in terms of the mall world in our international marketplaces today. So we don't expect to look at the mall world outside of the U.S. and say there needs to be a great amount of rationalization. In fact, I think, to a certain extent, we believe that the malls international markets reflect and represent the future how maybe U.S. malls are going to look, right, relative to not only rationalizing the square footage, but relative to what the different kinds of tenant mix might look like in U.S. malls as they go through the rationalization process.

For us though, because we are seeing consolidation of retailers in international markets. We think that creates an opportunity for us that there is going to be space opportunities created in good quality centers. So for us, Sharon, we think this is a growth opportunity for us in our international markets. For future expansion because they're just going to be those opportunities. We think there could be some really high-quality, low-cost potential opportunities for us to grow our presence in these markets. And of course, growing our presence isn't just about the physical world. It's about the concept of how we execute omni to serve customers in these marketplaces.

So that's where it gets to the right scale in each market to tip over, so we can execute the omni platform, which gives a whole additional boost to operating performance, both on the sales line and on the profit line as we do this. So I really think we have a big opportunity for profitable growth in our international markets over the next few years, Sharon. And of course, we will, as always, make sure we manage that growth with our culture and brand positioning right at the forefront of our thinking. But

we're certainly well positioned, I think, better position than any of our competitors to execute on those opportunities over the next few years.

OPERATOR: Our next question comes from Janine Stichter with Jefferies.

JANINE M. STICHTER, EQUITY ANALYST, JEFFERIES LLC, RESEARCH DIVISION: I want to dig a little bit more into back-to-school. It sounds like you expect the sales trend to pick up in 3Q a bit from where it is currently. Maybe you can provide some regional color on what you've seen in regions or districts that have already gone back to school, those that have gone back in-person, that would be a helpful color.

CHRISTOPHER CODINGTON WORK: Sure. Yes, I'm happy to provide some color. And I think this is where really understanding back-to-school has become increasingly challenging this year, obviously, just with the delayed Labor Day, delayed back-to-school, the impact of digital versus in-person schooling and just trying to understand where the health of our consumer is from -- or the financial health of our consumer, I should say.

So we did prepared some thoughts on this and kind of what we're seeing. And what I'll try to do is lay that out. I will disclose most of this is just domestic, as this is really where the bigger part of our business is and back-to-school. So as we look through that, I would tell you, like we said in our prepared remarks, our results have generally gotten better each week with last week or the fifth week of the period being positive, overall. By channel, we talked about comparable sales and where they're at in our prepared remarks. And we've seen -- while we see all categories down skate hardgoods has still been up, which is a good thing.

We did see some softness on the Labor Day weekend as compared to last year. But again, this is incredibly challenged to analyze because of the move out. So let me kind of try to phrase up from what we're seeing from the type of go back. So we've done some survey work across our -- all of our stores. And based on that survey work, what we're seeing is about 50% of our schools are going back with some sort of hybrid, about 40% of our schools are going back 100% remote, and about 8% of our schools are going back in-person with just a couple of percent that didn't come back.

So as we look at this, and then we start to apply sales to it because almost all of our regions and stores have gone back at this point. What we're seeing generally is that where we've gone back in person, those regions are performing the strongest with kind of a positive low single-digit comp. Where we've gone back in hybrid with some in-person and some remote learning we're seeing kind of a down low-single digit. And where we are going back, purely just remote, has been down over 10%. So we're definitely seeing the bigger challenges there.

The other piece for us is just the belief that this will continue on to September and August. And I'm sorry, in September and October, as we continue to expect to see some demand here into the next couple of months, and I think what it means to the future is we just have to continue to be super nimble. There's definitely a potential upside and downside, given a variety of scenarios that could play out here. And we look at those as our consumers' ability to spend going forward. Can we see this prolonged back-to-school that we and others are expecting? Or could there be a future back-to-school day? If we are able to manage through the pandemic and more and more districts and states decide they want schools to go back in-person will we see another back-to-school date potentially later in the fourth quarter or even in January of next year? What happens if more stimulus has gone into the economy? Where do unemployment levels go? How do we think about metering at peak if we're not able to increase the capacity in our stores? How does safety measures for our employees and our customers play into this? And what happens if we start to see more and more resurgence around the country?

And I, quite frankly, could probably go on. We have other things that we thought about as well. So I think we just have a lot to learn. We're going to remain really cautious. And as I said, nimble, it's kind of a keyword we're using. I think it's really helped us in the first 6 months of the year and really how we have to look at the back 6 months. And our teams are good at it. I think that's the piece that we're on top of, and we feel like regardless of how this plays out into Q3 and Q4 that our teams are good, and we can be on the top side of the retail marketplace for the back half of the year.

JANINE M. STICHTER: Great. That's incredibly helpful detail. And then just a follow-up on footwear. Can you elaborate a little bit more on the weakness? Is that just the inventory challenges you referenced or is it more of a back-to-school business typically? Or is there some change in trends? Any color there would be helpful.

RICHARD M. BROOKS: Yes. Janine, I'll start and let Chris add any comments he might have. I mean, some of this is going to be trend-related. Remember, we are on a multiyear run on footwear prior to this a couple of years ago, we had a long build up in our footwear cycle. And some of this is clearly a result of the pandemic and the supply chain discussions that Chris talked about.

So I'm not -- it's always -- is usually the case. There's multiple factors, I think, that drive where we're at now. Footwear been more difficult other than some categories prior to the pandemic. But we clearly have seen the supply chain impacts of, again, I think it's just how difficult the footwear industry is to manage because of this. Everyone has to take more risk in footwear because of the sizing that takes place in the footwear market. So -- but for us, I guess, the key thing in my mind is, I'll remind you what I always say about where we're at and how our business model works. Despite the challenges in footwear we managed of what I think are pretty remarkably good results. And as Chris said, no matter how third or fourth quarter turn out this year, the one thing I'm totally confident on is that I think we're going to outperform all of our competitors on a relative basis and most especially retail for that matter.

So the reason that is because our business is small, so dynamic with the number of brands we carry, of emerging brands we're carrying that become growth brands in our world, the number of departments and categories that we expose to our consumers, the lifestyles we represent across the marketplace. So one thing I'm confident on, no matter what the challenges are with footwear, I just want to remind everyone that our business is about managing the diversity of what we offer to deliver to our really self-expressive consumer. And our goal is always no matter what the transact is, whether it's a booming skate market, a tough footwear market, we always realize that we have categories and departments that are increasing, others that are decreasing. We have brands that are growing, brands that are shrinking.

The whole goal in our business is to build a diverse portfolio of departments, categories, lifestyles and brands that yield a positive comp across cycles. So that's kind of the headlines there. Some of it in footwear-specific, Janine, is related probably to growth trend as well as more importantly, in 2020, it is definitely related to supply chain and the challenge of the footwear industry in terms of the [size density], I think that's out there and the risk that we all have to take in inventory. But beyond that, just -- I'd just remind everyone about what our model is about. We're built to withstand down trending departments like that and have -- and capture share in other ways through other brands and through other departments to run gains. That's what we try to do.

OPERATOR: Our next question comes from Jeff Van Sinderen with B. Riley.

JEFFREY WALLIN VAN SINDEREN, SENIOR ANALYST, B. RILEY FBR, INC., RESEARCH DIVISION: Terrific work in Q2. Can you speak more about what you're seeing in the California market with closures? Did you see business there shift to digital? And then what have you seen in markets in California that have reopened?

CHRISTOPHER CODINGTON WORK: Yes. Sure, Jeff. Well, as we pointed out in our prepared remarks, right, we reopened the vast majority of our California stores in the second quarter only to close them again in the beginning of second week of July and ended July with those stores closed and then on into August as well. What we can tell you is that California was a big piece of our drop in sales, both in July and August, and really back-to-school to date and the numbers that we talked about.

It was one of the key drivers, representing probably about 1/3 of our decline overall on a consolidated level. So we definitely saw some pain there, even once we allocated the web sales there. Now we did see web sales go up and have pretty much seen that everywhere where we have closed, just like we did when we did the math closures in Q1 where in stores close, we start to see spikes in those regions in volume. And then more recently, we've opened a fair amount of those California stores with the exception of LA County and a few others. So we have seen a good rebound there as expected with the reopening. So we'll

see how that plays out as we move through Q3, but it was definitely a big impact on our -- the end of Q2 and our back-to-school to date.

RICHARD M. BROOKS: And I'd just add to Chris' comments, Jeff, that, of course, I'm sure you're aware most of California is going to be a virtual back-to-school.

So again, as we think about the impact of California, we're thinking that how schools go back is going to be reflective of how we capture whatever back-to-school turns out to be. So if it lengthens out and is prolonged, we think those are probably more likely the markets where we'll see that back-to-school stretched out. That's right.

JEFFREY WALLIN VAN SINDEREN: Okay. And could you touch on the rent withheld question, how you're thinking about that and maybe speak more about what level or magnitude of rent reductions we should think about as renewals come up, given kind of the tough spot that landlords are in?

CHRISTOPHER CODINGTON WORK: Sure. Well, let me talk about just the cash position overall and what we tried to lay out in this call, I mean we are incredibly happy with where we're at from a financial strength position. Obviously, the -- we entered the year in a good spot with really good planning and hard work to get there. And we've -- our teams have just managed incredibly well here through the first 6 months of the year to get us to where we are, which is at $299 million in cash with no debt.

That being said, we did want to disclose that we have just over $40 million in deferments and other costs that are there on the balance sheet that we think are real. So as we think about the cash balance, we try to rationalize it, it's probably somewhat something closer to $260 million in a more rationalized environment. And that's made up of not just deferrals, but the inventory position, which, as we mentioned, we are lighter on inventory than we'd like to. We would maybe not buy all of that inventory back, but we certainly would like to get a good portion of it, AP deferrals that we laid out as well as some payroll deferrals that we're taking advantage of. So as we plan to move through the year, we do expect a lot of that to have been paid out.

In regards to the rent situation, we're not going to get into a lot of detail other than to say that we are working with our landlords really closely. And this is a tough situation for them and for us. And we're trying to work with this in the best scenario for both of us. And so in some cases, that has led to deferment, in some cases, there's abatement. And in some cases, these will be things that we continue to work with as we evaluate centers into the future. And I don't think that's different than what we've seen over the last 5 to 10 years in the portfolio. Some malls are definitely winners in marketplaces and some malls are more challenged. And we have to work together to optimize them and get them to the right cost structure to make them work.

So I think we'll keep seeing that play out in this market. And we'll -- and I think over the long term, this is an area that we think we can benefit from our ability to maximize our store real estate with our 1-channel philosophy.

OPERATOR: Our next question comes from Mitch Kummetz with Pivotal Research.

MITCHEL JOHN KUMMETZ, SENIOR ANALYST OF FOOTWEAR, APPAREL VENDORS AND RETAILERS, PIVOTAL RESEARCH GROUP LLC: I guess I got a few of them. So I think we'll go through these pretty quickly. So Chris, on 3Q-to-date, I know you guys are down 14%. Can you say what percent of 3Q is normally in the books after 37 days of the quarter? Is it like 55%, 60% given the importance of back-to-school?

CHRISTOPHER CODINGTON WORK: Yes. Given the delay of where we are now, it's in that range, it's closer to that 60% that we are through the Labor Day weekend that we reported.

MITCHEL JOHN KUMMETZ: Got it. And then on gross margin, I think in your prepared remarks, you mentioned that product margins should be up year-over-year, maybe not as strong as it was in 2Q. But could you maybe speak more broadly about gross margin? Do you expect that to be up or down? I would imagine that if the sales are down in 3Q, that could put some

pressure on occupancy and if digital continues to outperform, maybe that puts a little pressure on shipping. So could you kind of maybe work through those components?

CHRISTOPHER CODINGTON WORK: Yes, absolutely. And I think this is really interesting how this has worked out because obviously, we -- with a 9% sales gain in the second quarter, we saw a pretty strong gross margin benefit, up 250 basis points. You're right, we talked about product margin being 170 basis points, which was a benefit. We also, at that level, see pretty good leverage across occupancy and some of our distribution costs. We also saw some benefits on shrinkage. And then we talked about web shipping being an offset to that, up 160 basis points although it leveraged as a percent of digital sales, which is an important callout because while we are seeing some elevation in gross margin because of the mix to web, on the flip side, it's leveraging across digital sales, which is important with how we measure the business.

So I think as we move into Q3, we are expecting product margins to be up, albeit although not what we saw in Q2, as you indicated. How we see gross margin is going to be more tied to the mix of the business and where sales overall go. And I think that's where -- to your part of your question or what you commented and what your question is if sales are down, that will provide some challenge on the gross margin side. We do expect web to be -- have a higher penetration of total sales in the third quarter. We have seen that through the back-to-school period we reported. And so that will also put some pressure on gross margin.

But at the end of the day, if we can continue to leverage that expense, we do think it could still be a benefit to our overall bottom line. So we're trying to really manage through this. It's pretty variable, as you pointed out, to the sales number. But if we can grow sales, we definitely think we still have opportunity to grow gross margin.

MITCHEL JOHN KUMMETZ: Got it. And then lastly, on hardgoods. I know that was your strongest performing category in the quarter, that's been the case for a few quarters now at least. Is there any way you can say how strong? I mean, was the growth year-over-year growth there, a multiple of the next best category? I mean there's been a lot of chatter about sort of equipment in general, whether it's bikes or you name it being particularly strong this summer.

So I guess, maybe a 2-parter. Maybe just maybe can you speak a little bit more to the growth of hardgoods? And then secondly, sort of how do you think that business into the back half as weather changes the skate typically fall off? Or do you kind of see this maybe morphing into maybe a strong snow hardgoods business? Just give a little more color on that.

RICHARD M. BROOKS: Let me start, Mitch, and then I'll ask Chris to follow up with some other one -- maybe some more details to your question, but we tend to look at these department-driven cycles as it tend to be multiyear cycles. So we had a multiyear cycle around footwear starting 4, 5 years ago that ran for a few years. So we're currently in year 2 of the skate hardgoods cycle.

And now the question would be, do you think that the impact of the pandemic is accelerated in the cycle, which is, I think, kind of embedded in your question there relative to what we've seen in other outdoor activities, right, that are taking place. And I'm not sure that we actually know the answer to that question. I think we think there are really multiple drivers to what's going on in the skate cycle today. And it first starts with the fact that we had 4 or 5 years of down trending in skate hardgoods. So we're kind of levelizing out would be what the first thing I'd tell you relative to consumer demand.

The second thing we see and we believe is true is that there are a significant number of women, more women buying skate hardgoods and skate products than ever before. And that's clearly what we hear from all of our teams across the country that has clearly been a difference in this cycle, that there are just more women out there, which is a pretty awesome thing to see. And we also believe that part of what we're experiencing now and the uptrend of the skate lifestyle and the skate hardgoods business is that it's more deeply embedded generationally now than it's ever been.

So this is a case where the young woman or young man may be buying their first skateboard and dad is buying his again to go skate with them. And I think that's this generational aspect that we're seeing that is a pretty -- also a pretty cool thing within this

market. And I think that -- what I'm basically saying, I think it makes the potential market -- the potential addressable market in skate hardgoods bigger in through this cycle.

And then lastly, what I would say about our unique position relative to this skate hardgoods business is that the consolidation in the marketplace over the last 5 to 10 years, there are just simply fewer retailers selling skate hardgoods. And so we have been positioned and we are a significant player in the skate hardgoods business around the globe where we do business. We, I believe, just are gaining a larger market share relative to the consolidation that's taking place, which is one of the things we've talked about relative to what retail consolidation means to our business and how we think there's more opportunity for us out there in the next 5 years.

So that's kind of, again, how we're thinking about it, Mitch, from kind of a trend perspective. I don't know if the pandemic is really accelerated or not. What typically I do know is these tend to be multiyear cycles that play out. And again, I think the -- as I described, many trends that are kind of driving this multiyear cycle. That, I'll let Chris maybe address the magnitude.

CHRISTOPHER CODINGTON WORK: Yes. So I'm going to stay away from talking about just comp numbers just because what we like to do when we talk about categories is to get to the total year. I think what's important to point out and we have disclosed is if we think about hardgoods in general, in 2018, it was 10% of the business. And in 2019, it was 13% of the business. So you can see the impact it had in year 1. And while we need to see how Q3 and Q4 plays out, the impact has been pretty substantial for this year as well, is really our only positive comping category, there is some significance there.

So again, I'll stay away from totally quantifying other than to say the kind of growth we've seen from '18 to '19 looks possible in '20 as well.

RICHARD M. BROOKS: And I guess I'd just add in. Chris, you can just confirm this for me. But Mitch, I think the size of our comps in skate hardgoods were significant. I don't think there's a big difference between their magnitude relative to other. They're obviously larger, but to the magnitude to other comps, I'm not sure there's a big difference between '19 and '20 really now.

CHRISTOPHER CODINGTON WORK: Yes, that's right.

OPERATOR: (Operator Instructions) Our next question comes from Jonathan Komp with Baird.

STEVEN D. NOWOTARSKI, RESEARCH ANALYST, ROBERT W. BAIRD & CO. INCORPORATED, RESEARCH DIVISION: This is Steve Nowotarski on for Jon. I guess my first one is just looking out, how are you thinking about the shape of holiday this year? I know some retailers have talked about maybe having a more extended season, having orders pulled forward, and especially as it pertains to maybe concerns about capacity with shipping and everything. So just any thoughts around the shape of holiday this year.

CHRISTOPHER CODINGTON WORK: Yes. I mean, I think it kind of ties in with how we're thinking about the rest of Q3 and Q4. We just have to stay super nimble. So we're very kind of focused on all the different trends you've laid out as far as volume spreading out and what that might mean around the peak of like a Black Friday weekend, we're focused on what the in-store experience is going to be from a fact of like, will we have metering? Or will we have challenges getting people in our doors? How we'll communicate to them? And we're honestly focused on things even like if, let's say, that schools go back to school more uniformly in January, what would that mean to our business?

So we have a lot of different scenarios we're playing through, which kind of comes back to what we've talked about earlier of just being nimble. And so I think there's a lot of unknowns. I tried to list some of them earlier. I think the other piece that -- obviously, we have a pending election as well, and we'll see what that means to the fourth quarter. So we see a lot of potential for upside. We see some potential challenges. And we're just going to do our best to navigate through that and see where we can drive this while also really taking advantage of opportunities that are out there for us.

I mean I think that's something else that Rick talked about in his prepared remarks, it's super important to where we're at. We've set ourselves up pretty well from a balance sheet perspective. And while we are very cognizant of whatever challenges can be ahead and ensuring that we can emerge from that in a position of financial strength, we also want to be smart about where potential investments could help us accelerate in this cycle. And we know that from the '08 and '09 recession, we learned a lot and some of our best investments we made over the last decade emerged from that cycle.

RICHARD M. BROOKS: And I'd just add, Steve, we do have a number of tactical things that we're trying to address that we hope will help us get -- as Chris said, build flexibility around the challenges we think we're going to see in the holiday cycle again around, does it get stretched out? What happens to peaks in the marketplace? What happens to digital web penetration? Does it go -- how much greater will it be? And what does that mean to the B2C shipping issues and all the challenges that come around that? So we have some tactical things we're working around that we think can help in all those things. We're not going to share all those at this level. But we hope that we can do things tactically that will help us bridge, that give us the ability to meet consumer expectations and consumer demand.

STEVEN D. NOWOTARSKI: Yes. Great. And maybe one more just -- obviously, it's been really impressive, your ability to manage costs this year. I guess looking out maybe higher level into next year and beyond. How are you thinking about the cost cuts in terms of kind of the permanent structural changes versus kind of more onetime items this year at a higher level?

CHRISTOPHER CODINGTON WORK: Yes. Thanks. I think this is one of the challenges we're going to have heading into 2021 and probably most retailers will as they think about their business. I mean we are very proud of how we've been able to manage through this. I think our teams have done a phenomenal job of -- we built the 2020 budget, and we rebuilt it. We've done tons of different scenario planning. We have kind of written the highs and lows and try to navigate through this. But as we think about moving back into 2021, there are -- the period the stores were closed, and we think there'll be some sales we can recapture, but there's a significant amount of cost that we've had to manage out.

And there are things that are really important to us in our overall philosophy. So as we think about moving into 2021, what we expect to have happen is there will be a step-up in our cost structure and specifically within SG&A, as a result of kind of driving the business back and not having some of the savings of whether they're rent abatements or saving credit -- payroll credits or reduced operating hours in malls or reduction of travel or some of our national events. And then starting to layer those back in, where they make sense. And I think one of the things we're figuring out here over the back 6 months of this year is what that looks like.

And something will definitely be coming back to you guys with most likely during our Q4 call, but maybe even a little bit in our Q3 call of trying to outline some of that because it is going to be important to make sure we're aligned in that modeling because we do believe it's important to reinstate our national events. They're incredibly focused on training our store managers and moving them along to make them great salespeople and to develop new salespeople.

That being said, we're not totally clear what the first 3 to 6 months of 2021 is going to look like. And will we be able to bring all of our managers together? And will we be able to bring our district managers together? So those are things we're looking at. We're modeling and working with landlords on what do operating hours look like as we move into holiday and then outside of holiday, and how that might look as well as many other kind of operating procedures and management of marketing events and things like that here that we've done on the corporate side.

So over the long term, what I can tell you is there will be probably some sort of rationalization into 2021. And maybe even into 2022. But beyond that, we continue to believe in the philosophy we've executed on over the last couple of years, which is as we look at our more mature markets here in North America and the U.S. and Canada, it's how do we manage those markets on a low -- lower single-digit comp over the long term to really manage costs and make sure that we're making the right investments in the business, but also showing some leverage in the business.

And then on the international side, to Rick's comments earlier today, we still believe there's a lot of room for growth. And those markets are actually doing quite well despite the pandemic that we have going on here. And we have an international market in Canada that we have driven the profitability and strong cash flow. We think we can do the same thing in Europe and Australia with scale and how we manage those businesses. And we think they're continuing to make strides to that. And so we will manage their cost structure a little differently because they have elevated sales gains with the addition of units as well as strong comps in newer markets.

So they will probably see a more expense growth there, but still significantly less than the sales growth. So that we show that leverage and drive them to where we want them to be from a profitability perspective. So a lot to do here, a very complicated situation, but I think that we're well positioned to navigate through it.

OPERATOR: I'm showing no further questions in queue at this time. I'd like to turn the call back to Mr. Brooks for closing remarks.

RICHARD M. BROOKS: All right. Thank you. And I just want to close today's call with a big thank you to all of our teams around the world. And our brand partners, too, for all their hard work through 2020. And we really appreciate an amazing effort by everyone to really help us serve our mutual customers everywhere we do business. So thank you, everybody, and we look forward, again, to talking to all of you when we do release the third quarter earnings in December.

Thanks, everybody.

OPERATOR: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

---- Index References ----

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